

Before the
Federal Communications Commission
Washington, DC 20554

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FEDERAL COMMUNICATIONS COMMISSION
U.S. DEPT. OF THE TREASURY

In the Matter of)

Prescribing the Authorized)
Unitary Rate of Return for Interstate)
Services of Local Exchange Carriers)

CC Docket No. 98-166

REBUTTAL COMMENTS OF THE VIRGIN ISLANDS TELEPHONE CORPORATION

The Virgin Islands Telephone Corporation ("Vitelco") through its undersigned counsel, respectfully submits its Rebuttal Comments in the above-captioned proceeding, pursuant to 47 C.F.R. §§ 65.103 (b) and 65.104 (c) and the Commission's *Notice* initiating this proceeding.¹ In its *Notice*, the Commission invited submissions and comment concerning whether it should "represcribe the authorized rate of return for interstate access services provided by" incumbent local exchange carriers ("LECs").

In its Direct Comments, Vitelco stated that this proceeding is, at best, premature. Numerous commenters joined Vitelco in recognizing the substantial regulatory and competitive uncertainty facing local exchange carriers particularly smaller and rural carriers. It makes no sense to divert attention and resources to conduct a wholesale reexamination of the rate of return

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¹ Prescribing the Authorized Unitary Rate of Return for Interstate Services of Local Exchange Carriers, Notice Initiating a Prescription Proceeding and Notice of Proposed Rulemaking, CC Docket No. 98-166, FCC 98-222 at 2, ¶ 1 (Oct. 5, 1998) ("*Notice*").

mechanisms at this point, while the Commission is still in the midst of implementing sweeping reforms ushered in by the 1996 Act.

Vitelco also noted that reducing the unitary rate of return, as predictably advocated in this proceeding by the largest domestic interexchange carriers,² would cause substantial harm to smaller, rural carriers, and would have the twin perverse effects of slowing investment in local facilities and muting competition. These interexchange carrier ("IXC") commenters offered little to answer Vitelco's core arguments about the substantial regulatory and competitive uncertainty in the local markets today, and the heightened risks faced by local carriers. Moreover, these parties largely ignore the extraordinary circumstances faced by Vitelco, and other smaller local carriers serving rural and insular areas, with the unique cost, demographic and geographic challenges they face.

The IXC superpowers also joined to support the accounting approach advocated by the General Services Administration. Vitelco agrees with numerous commenters who pointed out that GSA's methodology is replete with errors and faulty assumptions, all of which combine to skew downward its bottom line assessment of the current cost of capital.³ In the end, as demonstrated in the accounting submissions of several parties, if local exchange carriers' cost of capital is assessed on the basis of sound accounting principles, and in recognition of this environment of heightened regulatory and competitive risk, it is evident that there is no need to conduct a represcription proceeding at this time.

² See AT&T Reply at 2-3 (note: all responsive submissions filed in this proceeding on March 16, 1999 are referred to herein as "Reply" comments); *see also* MCI Reply at i; GSA Reply at 4.

³ See USTA Reply at 8-10 (filed by the United States Telephone Association, National Telephone Cooperative Association, National Rural Telecom Association, Organization for the Promotion and Advancement of Small Telecommunications Companies, Independent Telephone and Telecommunications Alliance, and National Exchange Carrier Association); Bell Atlantic
(Continued...)

I. THIS IS A BAD TIME TO REPREScribe THE UNITARY RATE OF RETURN, GIVEN THE SUBSTANTIAL REGULATORY AND COMPETITIVE UNCERTAINTY FACING LOCAL EXCHANGE CARRIERS

A. Local Exchange Carriers Face A Rapidly Changing and Unpredictable Regulatory Landscape

The Comments reflect that it would be unwise to construct a new unitary rate of return structure on the shifting sands of local telephone regulations. It would be far wiser to allow the dust to settle. The historical regulatory frameworks governing universal service and access issues are in the midst of being completely reworked by the Commission. While this regulatory transformation impacts all LECs, for a number of reasons, this uncertainty has an exaggerated affect on smaller local exchange carriers that serve rural and insular areas. Until the new rules have been defined, it is difficult, if not impossible, to foresee how capital markets will assess the impact of these changes.

Several commenters recognized that recent developments in the regulatory landscape, as well as the upcoming changes, serve to heighten the risks associated with providing exchange access services.⁴ For example, the universal service mechanisms are in a state of flux, with contributions and levels of support still completely up in the air, even for non-rural LECs. Modifications of the universal service support mechanism for rural LECs have not yet been proposed and are not scheduled to take effect for two years *at the earliest*. Inability to predict levels of universal service support represents a risk that is especially pronounced for smaller, rural carriers such as Vitelco for whom such support represents an especially high proportion of

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Reply at 2-5; GTE Reply at 2-7; US WEST Reply at 5-11.

⁴ See SBC Reply at 2; USTA Reply at 5. Indeed, USTA notes that many of the new regulatory requirements incumbent LECs are required to fulfill under the 1996 Act come with no assurance that they will be able to recover the costs they are required to incur. *Id.*

revenue. In fact, Vitelco estimates that it would be forced to raise its basic residential rates by approximately 68% to maintain current revenue levels in the event that universal service support were, for some reason, eliminated.

The three parties urging the Commission to slash the unitary rate of return each attempt to downplay the impact of this regulatory uncertainty on the cost of capital. AT&T, for example, posits that the heightened risk associated with widespread regulatory uncertainty is completely reflected in RBOCs' current stock prices.⁵ Contrary to AT&T's assertion, however, it is not a simple thing to see into the future. Indeed, the investor that knows the outcome of still-undecided Commission rulemakings, and can accurately predict the corresponding "winners" and "losers" in these proceedings, has unique and valuable information that we dare say even the Commission does not yet have.

GSA, seeking to downplay the heightened risk facing LECs, suggests that, while small and medium-sized ILECs may face unique challenges in the new regulatory and competitive environment, the danger of a "credit squeeze" is alleviated because of unspecified "new programs that the Commission is developing in response to the Telecommunications Act."⁶ This is wrong: there are no "new programs" in place designed to undo the extensive damage that could be done to rural LECs in this proceeding. The Commission should not rely on GSA's vague assertion that an unjustified reduction in rate of return will simply be balanced by other programs.

⁵ See AT&T Reply at 22.

⁶ GSA Reply at 15.

B. Opening Local Markets to Competition Has Made It More Difficult To Predict Local Access Revenues

As Vitelco did in its Comments, numerous parties noted that the 1996 Act has ended the relative predictability previously experienced by investors in local telephone companies.⁷ The advent of competition has heightened the competitive risk faced by LECs, as interexchange carriers, competitive local exchange carriers, and other new entities have emerged to pose serious competitive threats and mine away at the LECs' customer base. Furthermore, as USTA recognized, such risks have been heightened by mega-mergers such as AT&T's acquisition of TCI's vast cable infrastructure and strategic alliances like MCI Worldcom/AOL/Compuserve.⁸ The risks associated with local competition are particularly acute for Vitelco. Successful cherry-picking by AT&T or others will heavily impact a smaller carrier like Vitelco, as it relies extensively on a few large users and would be particularly sensitive to sudden changes in revenue. In sum, it simply makes no sense to prescribe a new, static rate of return based on a snap-shot of conditions taken today, just as local competition is beginning to take hold.

While AT&T's own experts recognized the heightened "risk that access customers will bypass the incumbent LEC's network as other alternatives become available,"⁹ it attempts to side-step this issue. AT&T offers a simple solution to investors concerned about LEC losses: *hedge your bets*. Specifically, AT&T suggests that "an investor can diversify the negative effects of competition on an incumbent LEC stock by . . . purchasing stock in the incumbent LEC's competitors as well."¹⁰ This strategy would offer little consolation to Vitelco's investors, and

⁷ See US WEST Reply at 8-10; USTA Reply at 4.

⁸ See USTA Reply at 4.

⁹ AT&T Reply, Affidavit of Bradford Cornell and John I. Hirshleifer, p. 4.

¹⁰ See AT&T Reply at 26.

would do nothing to help the company raise capital. Indeed, to suggest that any impact on Vitelco's stock price resulting from lost revenues due to unpredictable regulatory action or competitive entry will be met one-for-one by an increase in AT&T's stock is ridiculous. In any case, incumbent LECs all have the constitutional right to charge rates sufficient to earn a fair rate of return.¹¹

Both MCI and GSA even suggest that heightened investor concerns about the risk of burgeoning competition may be *irrelevant*.¹² Specifically, GSA speculates that ILECs have "little need to access the capital markets to raise new funds for their operations" because cash earnings are sufficient to cover construction requirements.¹³ This is not only unfounded, it is patently untrue, and dangerously downplays Vitelco's legitimate need to access capital markets.

Moreover, represervation could squeeze the profit margins associated with providing local service, thereby discouraging new infrastructure investment and could even have the perverse effect of *discouraging* new carriers from entering a local market. If local rates are repressed, competitive LECs would have an even harder time making a profit, given the sizable start-up costs associated with local entry.

II. NUMEROUS COMMENTERS CITED ERRORS AND DISTORTIONS IN GSA'S PROPOSED ACCOUNTING METHODOLOGY

GSA and the powerful IXC's offered accounting analyses that attempt to show that the RBOC holding companies, on the whole, currently face lower costs of capital than they faced in 1990. In their comments, a number of parties, including local exchange carriers, were quick to

¹¹ See *Hope Natural Gas Co. v. Federal Power Commission et. al.*, 320 U.S. 591, 603 (1944).

¹² MCI Reply at 12; GSA Reply at 14-15.

¹³ GSA Reply at 14-15.

point out serious flaws in GSA's accounting methodology.¹⁴ Vitelco supports the analysis offered by USTA, and other LEC commenters, which demonstrates the unreliability of GSA's conclusion that LECs face a cost of capital below the currently-prescribed 11.25% level. For example, Vitelco agrees with USTA that GSA's reliance on a capital structure based on book values. USTA also was correct in noting that GSA's decision to look only at an ILEC's previously issued stock, rather than assessing an ILEC's cost of new debt and new issues of stock, combine with other errors to misstate ILECs' cost of capital.¹⁵

Moreover, Vitelco notes that it is unreasonable and arbitrary for AT&T to deduct a further 0.5% from its already-flawed calculation of ILECs' cost of capital. AT&T offered a laundry list of claims which supposedly justify this arbitrary adjustment -- all of which lack merit. For example, AT&T's conclusion that access services are among the *least risky* of RBOCs' telecommunications services¹⁶ has been demonstrated to be false by the ILEC commenters.¹⁷ AT&T also suggests that such an adjustment is necessary to correct for "phantom property" which, it argues, was improperly reported on RBOCs' accounts.¹⁸ AT&T is plainly jumping the gun on this point, as the Commission has, by no stretch of the imagination, reached any final conclusion at all about these questioned items.¹⁹

¹⁴ See, e.g., USTA Reply at 8-10; Bell Atlantic Reply at 2-5; GTE Reply at 2-7; US WEST Reply at 5-11.

¹⁵ See USTA Reply at 8-10.

¹⁶ See AT&T Reply at 28-29.

¹⁷ See GTE Reply at 6.

¹⁸ See AT&T Reply at 29-30.

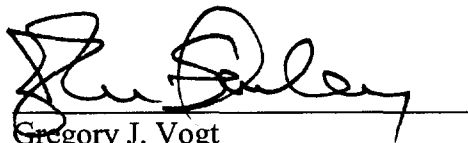
¹⁹ See AT&T Reply at 29-30. Indeed, the FCC's audit report, on which AT&T relies, was merely preliminary, and was released with two dissents as well as qualifying language from a third Commissioner urging further review. See "FCC Releases Audit Reports on RBOCs' Property Records," Report No. CC 99-3 (February 25, 1999); see also Separate Statement of Commissioner Ness.

In the end, when adjusting for these omissions and distortions, several commenters reached results that demonstrate that local exchange carriers face costs of capital near, or in excess of, the current 11.25% benchmark.²⁰ These calculations underscore that there is little reason for the Commission to divert attention and resources from its ongoing implementation of the 1996 Act to engage in a time-consuming rate represcription assessment.

III. CONCLUSION

A balanced calculation of ILECs' cost of capital demonstrates that the Commission should not represcribe the authorized rate of return at this time. Moreover, this conclusion is reinforced by the fact that local markets and the regulatory environment are both in a state of flux -- making this a poor time to reassess the rate of return. Accordingly, the Commission should not alter the authorized rate of return in this proceeding.

Respectfully submitted,



Gregory J. Vogt
John P. Stanley
WILEY, REIN & FIELDING
1776 K Street, N.W.
Washington, D.C. 20006
(202) 719-7000

Attorneys for Virgin Islands Telephone
Corporation

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²⁰ See Bell Atlantic Reply at 2; GTE Reply at 7; SBC Reply at 1; USTA Reply at 6.